1949 VALUE ADVISORS

# Quarterly Review – Q3 2015

Global equity markets declined during the period under review primarily due to investor worries about the slowing Chinese economy and its likely negative impact on global growth and corporate profits. The third quarter ending September 30, 2015 was the worst performing quarter for global stocks in four years. Most of this decline came during August and September, coincident with the launch of the 1949 Global Value Strategy at the end of July. Against this difficult backdrop, the 1949 Global Value Strategy fell 7.0%, compared with the 9.7% decline of the MSCI World Index (in US$) for the partial quarter.

## Market Overview

Despite favorable economic data in the US, the S&P 500 Index declined 6.4% during the quarter. The US Federal Reserve decided to defer raising interest rates, citing worries about the global economic outlook, even after Q2 GDP was revised upwards, from 3.7% to 3.9% (annualized). In Europe, improved consumer sentiment and approval of another Greek bailout package offset corporate profit warnings from Rolls Royce and others, and news that Volkswagen had misled regulators in emissions tests on their diesel vehicles. While concerns about China were a drag on markets in general, S&P's downgrade of Brazil's sovereign debt to non-investment grade also damaged emerging market sentiment. The MSCI Emerging Markets Index (in US$) fell 17.8% during the third quarter, its worst quarterly decline since 2011. In Japan and the rest of Asia, stocks fell broadly during the quarter. Japan's TOPIX Index lost 12.8% (in yen) on signs of weakness in Japan's economy, while the Hang Seng Index in Hong Kong lost 19.8% largely due to weak Chinese economic data. The US dollar was slightly weaker during the quarter against most major currencies, losing 2.2% versus the Japanese yen and 0.3% versus the euro, but gaining 3.7% against the British pound sterling. China devalued its renminbi by slightly more than 2% in August, a move towards a more market driven determination of its exchange rate in the hope of being included in the IMF's basket of reserve currencies.

## Portfolio Commentary

While the 1949 Global Value Strategy currently has limited exposure to emerging markets, we have historically focused more on developed world markets. This bias towards developed markets helped our performance during the period under review, but sectoral exposure to mining stocks negated much of this benefit due to the very high correlation between mining stocks and emerging markets, which account for more than half of total global demand for many metals. Commodities were the worst performing asset class during the quarter, followed closely by emerging market equities.

Portfolio positions which contributed most positively to performance during the partial quarter include Industrias Bachoco SAB de CV (+7.0%), Birchcliff Energy (+4.5%) and Franco-Nevada Corp. (+7.9%). Bachoco is the leader in the Mexican poultry industry (with 35% market share) and one of the ten largest poultry producers globally. With operations in both Mexico and the US (80% and 20% of operating income, respectively), Bachoco owns and manages more than a thousand farms, 11 processing plants, 20 feed mills, and 24 hatcheries. While the poultry industry is cyclical in nature, there are meaningful secular demand drivers important to the investment thesis – chicken and eggs are the largest (62%) source of proteins consumed in Mexico. Per capita consumption of chicken in Mexico averaged 29.5 kg in 2014, versus 27.3 kg in 2009, and growing 3-4% annually versus only 1-2% in the US. In addition, relative to other South American countries such as Peru (40kg consumption, same per capita income as Mexico), secular demand for poultry in Mexico is well supported. Chicken is considered both healthier and more economic than beef or pork, likely to support pricing of poultry through the cycle as higher priced beef and pork continue to lose market share. Mexicans have a cultural preference for freshness, with a third of sales in the "live" format and only 20% sold as cuts. Bachoco's integrated production platform and distribution network are critical in serving fresh products daily, and serve as a competitive advantage and barrier to potential new entrants. Bachoco's products usually carry a premium to other brands, an illustration of rare customer brand loyalty in commodity food products. Recent consolidation in the Mexican poultry industry should also support rational pricing, with 62% of the market now supplied by Bachoco and Pilgrim's Pride of the US. Despite these important factors supporting the long term investment thesis for Bachoco, worries about the shorter term pricing cycle has driven many industry participants' shares to an attractive level. Industrias Bachoco shares have held up better than its US competitors, exhibiting great resilience during the quarter's market decline because of its stable business and clean balance sheet. With its shares trading for less than 7x estimated 2015 EBIT and more than 20% of its market cap in net cash, we believe the downside is limited and the risk of a permanent loss is minimized, while the company continues to generate significant long term shareholder value. A more appropriate multiple on EBIT for a company like Bachoco with clear competitive advantages, generating strong free cash flow and reinvesting in their business, earning mid-teens returns on capital would imply fair value 40-50% higher than its current share price.

Both Birchcliff Energy and Franco-Nevada shares performed well during the quarter, and their respective investment theses were discussed at length in last month's inaugural letter. In the case of Birchcliff, shares were supported by stable Canadian spot natural gas prices in August and September. As one of Canada's lowest cost producers of natural gas, being able to generate free cash flow at today's depressed natural gas prices should allow Birchcliff to eventually realize a much greater fair value for their assets over the medium and long term. Franco-Nevada Corp. is the leading gold-focused royalty company, providing investors with gold price and exploration upside optionality, while limiting many of the risks associated with operating companies. We view our position in Franco-Nevada as a proxy for the price of gold, since its primarily revenue-based royalty model gives us predictable cash flows based upon the price of gold during the reporting period. Shares of Franco-Nevada performed well during the period under review as investors sought safety in gold related investments as markets declined. While its use as a hedge during a garden-variety cyclical market downturn isn't reliable, we are pleased that it helped buffer declines elsewhere in the portfolio during the recent period.

Portfolio positions which detracted most from performance during the partial quarter include German utility E.ON (-35.4%) and Franklin Resources (-17.9%). E.ON is one of the world's largest integrated power and gas companies, after being founded in 1920 as Germany's national power company. Deregulation sparked a wave of M&A that resulted in E.ON acquiring significant assets in the US and Europe. In 2009, following the financial crisis and a collapse in commodity prices, management reversed course, selling more than €20 billion in assets. At the end of 2014, E.ON management announced a plan to split the company into two, spinning off its legacy upstream fossil-fuel power generation and commodity business into a new entity to be named Uniper. Using trading multiples for comparable companies, and private market values for assets that will be sold, we believe there to be significant latent value that could be unlocked by the split. In early September 2015, however, E.ON announced a change to the structure of its planned split in response to liabilities relating to E.ON's nuclear power generation facilities. Contrary to its initial plan, the nuclear assets will now stay with E.ON in order to alleviate political and regulatory risk associated with a new German law which would extend unlimited liability to E.ON even if it transfers the nuclear assets to Uniper. The change in the spin-off structure should have little bearing on the values of the two businesses, or the opportunity that we perceive in E.ON's depressed shares. A week later, in mid-September, an article published in German news magazine *Der Spiegel* reported that nuclear provisions by German utilities could increase by €30 billion. The article cited a draft version of an independent stress-test audit, and used a worst case scenario to determine the required level of provisioning by German utilities. Shares of all German utilities declined precipitously in knee-jerk response to the report. The assumptions described in the article were overly harsh and inconsistent with how other European countries had recently determined provisioning requirements. We believed that when the actual stress test audit results are released, the worst case scenario described in the article would likely not be the regulator's central scenario. Based on this belief, we added to the position during the quarter, maintaining our target weighting of 5.0%. Assuming a reasonable increase in provisions, E.ON shares trade at a 50% discount to the sum of its parts (€16/share). We believe there is a margin of safety against a permanent capital loss, while the early 2016 separation should unlock latent value as the market ascribes a more appropriate fair value to each of E.ON's two businesses.

Franklin Resources is a global investment management company with more than $770 billion in assets under management (AUM) across equity, fixed income and alternative asset classes. Shares in Franklin Resources are highly correlated with the general equity and fixed income markets, largely explaining the poor performance during the recent quarter. As markets decline, AUM and revenues also decline, negatively impacting corporate profit margins and returns on capital. Franklin has experienced net fund outflows due to poor performance in key products such as global bonds and emerging market equities. In general, we believe asset management is a very attractive business, with economies of scale driving strong margins and profitability, with typically debt-free balance sheets. Franklin is no exception, having near industry-leading profit margins and net cash equivalent to 24% of its market cap. Despite this excess cash suppressing returns, Franklin has earned more than 20% return on equity since 2010. Earnings have compounded by 12% CAGR over the last five years, about the same pace as growth in book value per share. Overall, Franklin has built a valuable franchise by delivering solid long term performance across all products and platforms, new product innovation and world-class distribution. Having spent part of my career with Franklin, I can speak with conviction about the quality of the organization. Long term value creation in the asset management business can be overshadowed by short term capital market fluctuations, or expectations of heightened market volatility negatively impacting asset flows. This is the case today, with Franklin shares down 35% from its recent 2015 high. We believe that Franklin's long-term strategic advantages and ability to continue to compound shareholder value is underappreciated by the market today, with shares trading for less than 7x current year estimated EV/EBIT, a level that historically has offered patient investors a great opportunity to buy shares in a world-class asset manager. The current discounted share price, in combination with large net cash on their balance sheet, should offer investors a comfortable margin of safety against permanent loss, while the company's recent aggressive share repurchases reinforce our conviction in the long-term investment thesis.

**Outlook**

As a conservative value-driven global investment firm, we aim to satisfy two investment objectives over time – preservation of capital and growth of capital. Over the long term, we expect to outperform our global peer group average and the MSCI World Index with less absolute risk. We endeavor to achieve these objectives by investing in global equity securities trading at a significant discount to appraised value (a "margin of safety"), a risk-averse investment strategy designed to avoid a permanent loss of capital, and to realize capital appreciation.

Our aim is to create an excellent long term performance record by avoiding a permanent loss of capital, mitigating losses during temporary market downturns, while participating in market upturns. While our focus is on satisfying these objectives over the long term (rolling 3 – 5 year periods), we will occasionally succeed over shorter time periods during market environments that reward our conservative approach. The most recent quarter, although not without disappointment, exhibited these characteristics. As a global unconstrained and benchmark agnostic investment strategy, we have the flexibility to take advantage of changing market opportunities through time. Our focus on capital preservation, combined with our experience in navigating these varied environments since 1993, gives us the confidence to act in a prudent yet opportunistic fashion. As we embark upon this exciting journey together, we will be diligent in our search for undervalued securities of quality companies that will help us meet or exceed our investment objectives.

Thank you for your support, and we look forward to serving your global investment needs for many years in the future.

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